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Indian operations of foreign enterprises
A BEPS perspective

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On 5 October 2015, the Organisation for Economic Co-operation and Development [OECD] released the final action plan in relation to Base Erosion and Profit Shifting [BEPS]. The G20 in their summit at Turkey on 15 and 16 November endorsed the package of measures and strongly urged the timely implementation of the project and encouraged all countries and jurisdictions, including developing ones, to participate.

This paper seeks to capture some of the key potential impacts of BEPS for multinational enterprises [MNEs] that are operating in India. It is pertinent to note that other than postponement of the implementation of the Indian GAAR on account of the BEPS project, the Indian government has officially not made its stand known on BEPS. The impact discussed below will depend to a large extent on the rules proposed in the Indian tax law and the positions India adopts in the multilateral instrument or bilateral tax treaties.

Permanent establishment [PE]

- **Marketing subsidiaries:** Many MNEs operate in India through a subsidiary to provide marketing support to the products of the group – typically the Indian subsidiary receives a fee or commission that is taxable in India, whereas the overseas group entity is not taxable in India on the profit of the sales, in the absence of a PE in India. The proposed expansion of the definition of agency PE in the context of conclusion of contracts and the inability of the Indian subsidiary to be regarded as an 'independent agent' could expose a part of the overseas group entity's profit on sale of products to be taxed in India, depending on the facts of the case.
- **Liaison offices:** A significant number of foreign companies have set up liaison offices in India – the argument taken in such cases is that the activities of the liaison office are preparatory or auxiliary in nature, and accordingly, no PE is created. With the proposed tightening of the conditions relating to preparatory or auxiliary activities, coupled with the anti-fragmentation rule for specific activity exemptions, the Revenue authorities are likely to look at such liaison offices in greater detail.
- **Digital businesses:** Depending on the facts and circumstances of digital businesses, the narrowing of the specific activity exemptions (say, proposal that delivery of goods needs to be a preparatory or auxiliary activity to qualify for the exemption) and proposed widening of the agency PE rule could lead to creation of a PE of such digital businesses in India.
- **EPC contracts:** India has a significant number of EPC contracts being executed by MNEs – in many cases, various group entities execute different parts of the project and individually no PE is created for the group entities. The proposed rules relating to splitting of contracts could lead to the various group entities creating a PE in India and being taxed in India.

Tax treaty abuse

- **Intermediary companies:** A significant amount of investment flows into India from companies incorporated in intermediary jurisdictions, which have favourable tax treaties with India. To counter tax treaty abuse, the BEPS project has laid down minimum standards, involving a limitation on benefits [LOB] rule and a principal purposes test [PPT] rule. The LOB rule limits treaty benefits to entities that meet the prescribed conditions whereas the PPT rule is akin to a general anti-avoidance rule [GAAR] for denial of treaty benefits. The Revenue authorities are likely to challenge intermediary holding structures for investment into India under the proposed LOB / PPT rule under tax treaties and the GAAR under the Indian tax law that will be effective from 1 April 2017.

Financing transactions

- **Hybrid instruments:** A large number of foreign companies invest in India by subscribing to Compulsory Convertible Debentures [CCDs] issued by their Indian subsidiaries. Till the time of conversion to equity, India would generally regard the CCDs as debt and grant a tax deduction for interest on such CCDs. With the proposed linking rules in relation to hybrid instruments contemplated under BEPS, if the home country of the CCD-holder regards the instrument as equity and does not tax the dividend, India may deny a deduction for such interest. Another related rule in relation to hybrid instruments is imported hybrid mismatches – pursuant to this proposal, the Indian Revenue authorities may question deductibility of interest in case of all overseas borrowings.
- **Interest deductions:** India is typically regarded as a high tax jurisdiction from the corporate tax perspective. The BEPS proposal to limit interest deductions by following a fixed ratio rule may also impact the Indian tax position of MNEs.

Transfer pricing

- **Non-recognition:** The Indian tax authorities have historically resorted to re-characterising transactions challenging the substance of the transaction, in the pre-BEPS period as well. Indian authorities have usually re-characterised transactions such as: (i) domestic advertising and marketing expenses as provision of brand building services; (ii) outstanding receivables or shortfall in price of shares issued to overseas associated enterprises as loan extended. Given that the new guidance focuses on commercial rationality rather than substance, MNEs need to factor in and evaluate the impact of the new guidance on the positions adopted by them in India.
- **Low value-add services:** India is considered a preferred jurisdiction for outsourcing activities and therefore many MNEs have incorporated subsidiaries in India for provision of support services. The manner in which the new guidance defines low value-add services, it may cover within its purview a significant part of the support services currently provided by India. The proposed mark-up of 5% for these services is significantly lower that the Indian safe harbour rules as well as the margins determined by Indian tax authorities during audits. Given the present definition of low value-add services, it is unlikely that the Indian authorities may adopt the simplified approach in its current form.
- **Intangibles and risk:** The Indian view on marketing intangibles and R&D intangibles in relation to software and other pharmaceuticals, has largely developed on the basis of judicial precedents and numerous MNEs are facing litigation in India on this aspect. The revised guidance emphasises supplementing the contractual arrangement through examination of the actual conduct of the parties and also emphasises on value created by the group companies through functions performed, assets used and risk assumed in development, enhancement, maintenance, protection and exploitation [DEMPE] of the intangible. The guidance also states that the risk related returns are to be aligned to control of risk and financial capacity to assume risk. Such an approach finds support in the Indian context. Though, reviewing and aligning the existing positions with BEPS guidance may pose challenges.
- **Location savings:** Location savings are referred to the cost savings attributable to operating in particular low cost jurisdictions, such as India. Indian tax authorities at lower level have been of the view that the entire benefit of location savings should be retained by the Indian group entity. However, such an approach has not been favoured by the Indian judiciary in several judicial precedents. The divergent Indian view would need to be aligned to the BEPS guidance which provides a step wise approach to determine the allocation of location savings

Documentation and CbC report

- **Transfer pricing documentation:** From an Indian perspective, rules may need to be framed to provide for maintenance of information contained in master file and Country-by-Country [CbC] report as the Indian transfer pricing regulations currently do not require maintenance of such information. Further, India together with a few emerging countries, has requested for additional transactional data (beyond that required in master file and local file) regarding related party interest payments, royalty payments and especially related party service fees, which the MNEs having Indian operations will need to bear in mind.

Indirect taxes

- **VAT / GST:** The OECD recommendations in the context of digital economy that links indirect taxes to BEPS shall require an in-depth analysis / consideration of businesses having global presence or making investments in businesses of other countries to manage their impact, which could be significant within a supply chain. With these changes in business transformation, indirect taxes shall also have a significant impact and play a vital role especially in India where GST, which is going to be a destination based tax, is likely to be introduced.

Way forward

As a member of the G20 and an active participant in the BEPS project, India is committed to the BEPS project outcome and implementation. Therefore companies operating in India need to be aware of and constantly monitor the changes that India may bring about in its domestic law and tax treaties, including India's position on the multilateral instrument, in order to evaluate the BEPS impact in relation to Indian operations.

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